No. 9883

In the United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT.

ESTATE OF MAUD GILLESPIE, DECEASED, PARMER A. GILLESPIE, EXECUTOR, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Upon Petition to Review a Decision of the United States Board of Tax Appeals.

BRIEF for PETITIONER.

HAROLD E. RORSCHACH,
JACK L. RORSCHACH,
HAROLD C. HARPER,
Counsel for Petitioner.

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BRIEF *for* PETITIONER.

Opinion Below.

The finding of fact and opinion of the United States Board of Tax Appeals is reported in 43 B. T. A. #52 and is set forth in the printed record at page 142.

Jurisdiction.

The Commissioner of Internal Revenue made a determination that there was a deficiency in the income tax of the taxpayer, Maud Gillespie, in the amount of $1,476.55, by registered letter dated March 2, 1939, directed to the taxpayer, for the calendar year of 1935 pursuant to section 272 of the Revenue Act of 1934 (R. 8).

Thereafter, on May 25, 1939, the taxpayer petitioned the Board of Tax Appeals for a redetermination of the deficiency (R. 1). On March 20, 1940, the United States Board of Tax Appeals entered its decision, from which decision appeal was perfected to this court by a petition for review filed June 19, 1941, pursuant to authority to review a decision of the United States Board of Tax Appeals by virtue of section 1142 of the Internal Revenue Code.

Maud Gillespie was a resident of Beverly Hills, California, and filed her income tax return for the calendar year of 1935 with the Collector of the Sixth Collection District of California, located in the City of Los Angeles in the State of California within the jurisdiction of the United States Circuit Court of Appeals for the Ninth Judicial Circuit.

Statutes and Regulations Involved.

Revenue Act of 1928, section 44 (b):

> "*Sales of Realty and Casual Sales of Personalty.* In the case *(1)* of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or *(2)* of a sale or other disposition of real property, if in either case the initial payments do not exceed 40 per centum of the selling price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term 'initial payments' means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made."

Revenue Act of 1928, section 111:

> (a) "*Computation of Gain or Loss.* Except as hereinafter provided in this section, the gain from the

sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized."

(b) * * *

(c) "*Amount Realized.* The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

Revenue Act of 1928, section 113 (a):

"*Property Acquired After February 28, 1913.* The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except * * *."

Revenue Act of 1934, section 22 (b) (2):

"*Annuities, etc.* Amounts received (other than amounts paid by reason of the death of the insured and interest payments on such amounts and other than amounts received as annuities) under a life insurance or endowment contract, but if such amounts (when added to amounts received before the taxable year under such contract) exceed the aggregate premiums or consideration paid (whether or not paid during the taxable year) then the excess shall be included in gross income. *Amounts received as an annuity under an annuity or endowment contract shall be excluded from gross income the excess of the amount received in the taxable year over an amount equal to 3 per centum of the aggregate premiums or consideration paid for such annuity* (whether or not paid during such year), until the aggregate amount excluded from gross income under this title or prior income tax laws in respect of such annuity equals the aggregate premiums or consideration paid for such annuity. In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance, endowment, or annuity contract, or any interest therein, only the actual value of such con-

sideration and the amount of the premiums and other sums subsequently paid by the transferee shall be exempt from taxation under paragraph (1) or this paragraph." (Italics added.)

Regulations 86, relating to income tax under Revenue Act of 1934, promulgated by the United States Treasury Department, article 22 (b) (2)-2:

"*Annuities.* Amounts received as an annuity under an annuity or endowment contract include amounts received in periodical installments, whether annually, semi-annually, quarterly, monthly, or otherwise, and whether for a fixed period, such as a term of years, or for an indefinite period, such as for life, or for life and a guaranteed fixed period, and which installments are payable or may be payable over a period longer than one year. If an annuity is payable in annual installments, there shall be included in gross income only such portions of the amounts received in any taxable year as is equal to 3 per cent of the aggregate premiums or consideration paid for such annuity, whether or not paid during the taxable year, divided by the number of installments payable during such year. As soon as the aggregate of the amounts received and excluded from gross income equals the aggregate premiums or consideration paid for such annuity, the entire amount received thereafter in each taxable year must be included in gross income. The provisions of this article may be illustrated by the following examples: * * * ."

Revenue Act of 1934, section 44 (b):

"*Sales of Realty and Casual Sales of Personalty.* In the case *(1)* of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or *(2)* of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was

in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term 'initial payments' means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made."

Regulation 86 relating to income tax under the Revenue Act of 1934, promulgated by the United States Treasury Department, article 44-4, in part:

" * * * If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis as provided above and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value."

Revenue Act of 1934, section 111:

"(a) *Computation of Gain or Loss.* The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

"(b) *Amount Realized.* The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

Revenue Act of 1934, section 113 (a):

> "*Basis (Unadjusted) of Property.* The basis of property shall be the cost of such property, except that * * *."

Statement of the Issues.

On April 24, 1920, F. A. Gillespie and Sons Company, a corporation, was organized, under the laws of the State of Oklahoma, with a capital stock of $1,000,000.00 divided into 10,000 shares of $100.00 each. The stock of this corporation was held. 5 shares each, in the name of Maud Gillespie, F. A. Gillespie, and the three sons of Maud Gillespie and F. A. Gillespie: B. A. Gillespie, L. A. Gillespie, and P. A. Gillespie; the remaining 9,975 shares were held in trust by F. A. Gillespie under a trust agreement dated the 9th day of February, 1921 (R. 11-17). By the terms of this trust agreement, 1,995 shares were held in trust for the life of each of the members of the Gillespie family.

On May 15, 1929, F. A. Gillespie and Maud Gillespie entered into a separation agreement and property settlement (R. 17-26).

On May 15, 1929, F. A. Gillespie and Maud Gillespie entered into an agreement with F. A. Gillespie and Sons Company (R. 27-30). By the terms of this agreement, F. A. Gillespie and Maud Gillespie agreed to convey to the corporation all of the real and personal property owned by each, with the exception of some personal real estate and $100-000.00 in cash reserved by each; and in part consideration for the conveyance of this property, the corporation agreed to pay F. A. Gillespie the sum of $15,000.00 per year, and to Maud Gillespie the same amount; and, in addition, the corporation agreed that Maud Gillespie should receive dividends in the amount of at least $10,000.00 per year, and if funds were not available to be declared as dividends, the corporation agreed to pay Maud Gillespie from any source

the additional sum of $10,000.00. It was further agreed that F. A. Gillespie should not sell or transfer any of the corporation stock of which he was trustee without the written consent of a majority of the board of directors of the corporation.

Thereafter, the terms of the agreement were carried out; and between the years 1929 and 1932, conveyances were executed and delivered carrying out the terms of the agreement (R. 145).

Under the terms of the agreement, F. A. Gillespie and Maud Gillespie conveyed to the company the following property of the values indicated which they owned jointly:

U. S. First Liberty Loan bonds and Port of New Orleans, Louisiana, state bonds	$1,172,000.00
Empress Building, Tulsa, Oklahoma	150,000.00
Sundry lands and lots located in Oklahoma	22,512.00
Cash and accounts receivable	94,365.22
Sundry stocks	25,363.00
Total	$1,464,240.22

The costs of the above properties to F. A. Gillespie and the petitioner equalled or exceeded the above fair market values. Maud Gillespie was the owner of one-half of the above properties delivered to the company under the contract of May 15, 1929, and one-half of the cost of same was hers.

However, no payments were made to Maud Gillespie until the year 1932, at which time an adjustment was made for the amounts due under the agreement from May 15, 1929, to the end of the year 1932 (R. 148). Up to December 31, 1935, Maud Gillespie had received the sum of $94,894.01 under the terms of the contract of May 15, 1929 (R. 148).

Thereafter, on November 16, 1933, Maud Gillespie agreed to a suspension of the guaranteed dividend payment of $10,000.00 per year (Exhibit 1, R. 118) (R. 148).

During the calendar year 1935, Maud Gillespie received from F. A. Gillespie and Sons Company the sum of $17,-666.25, which she did not report on her tax return for that year as being taxable income. Thereafter, the Commissioner of Internal Revenue on March 2, 1939, sent a registered letter directed to Maud Gillespie in which it was proposed to assert a deficiency of income tax for the year 1935 in the amount of $1,476.55. The determination of this deficiency, as claimed by the Commissioner was by reason of his considering the sum of $17,666.25 as an annuity payment, the whole of which he claimed to be taxable, under provisions of 22 (b) (2) of the Revenue Act of 1934 (R. 9).

Thereafter Maud Gillespie filed her petition with the United States Board of Tax Appeals appealing from such determination by the Commissioner of Internal Revenue.

Thereafter, the case came on for a hearing on its merits before Member Hill on May 16, 1940, at which time the depositions of Charles Green and Maud Gillespie were received and oral testimony and documentary testimony submitted on behalf of the taxpayer.

The issues as made up by the petition as amended and the answers filed in reply thereto by the Commissioner of Internal Revenue and the testimony, exhibits and stipulation left for decision with the United States Board of Tax Appeals, substantially, these four questions:

(1) Was the payment made to Maud Gillespie in calendar year under the contract of May 15, 1929, by which F. A. Gillespie and Sons Company acquired property in excess of a value of $1,000,000.00 from F. A. Gillespie and Maud Gillespie, and which had a cost to them of more than $1,000,000.00, in the nature of a deferred payment

on the sale of the foregoing from which no profit could arise until the cost had been recovered?

(2) Was section 22 (b) (2) of the Revenue Act of 1934, unconstitutional and void in its application by the Commissioner of Internal Revenue to the facts herein?

(3) In any event, no more than \$15,000.00 was received by Maud Gillespie during the year 1935 from F. A. Gillespie and Sons Company under the contract of May 15, 1929, and which could be subject to any income tax statute; the remaining amount of \$2,666.25 being a loan to taxpayer from F. A. Gillespie and Sons Company.

(4) In the alternative, if any part of the sum of \$15,000.00 received by Maud Gillespie from F. A. Gillespie and Sons Company during the year 1935 was taxable, then only such portion of the \$15,000.00 is taxable as represents 3 per cent of what an annuity would have cost at May 15, 1929, as would have produced the sum of \$15,000.00 per annum during the lifetime of Maud Gillespie.

From the foregoing issues as framed, the Board of Tax Appeals, by Member Hill, determined that the corporation had agreed to pay petitioner two annuities, one for \$15,000.00 and one for \$10,000.00 (R. 142), annually and that the cost of acquiring these annuities on May 25, 1929, would have been \$327,562.50 (R. 150), and the balance of the value of the property delivered was a contribution to the company; and that, hence, taxpayer was taxable, in accordance with section 22 (b) (2) of the Revenue Act of 1934, on the amount of 3 per cent of \$327,562.50, or the sum of \$9,826.88. (R. 158)

The member of the Board holding against taxpayer's contention that the contract of May 15, 1929, constituted a sale of property transferred with payment to be made in annual installments (R. 150-152); and holding that section 22 (b) (2) of the Revenue Act of 1934 was constitutional in so far as it was sought to be applied in the instant case by

the Commissioner (R. 153); and holding further that the $2,666.25 was a part of the annuity payments received under terms of the contract of May 15, 1929 (R. 156).

Thereafter, motion for reconsideration was filed (R. 158) and denied. Decision was entered on March 20, 1941 (R. 160), and, thereafter, petition for review by the United States Circuit Court of Appeals for the Ninth Circuit was filed; and, thereafter, statement of points upon which the appellant relies for appeal was filed with this court.

Issues on Appeal.

Taxpayer contends that the Board erred in the following respects:

I.

In finding that the contract of May 15, 1929, between Maud Gillespie and F. A. Gillespie and F. A. Gillespie and Sons Company was not an ordinary contract of sale or contract for the exchange of capital assets the payment for which was on the deferred payment basis to petitioner extending over a period of years.

II.

In not holding that the application of section 22 (b) (2) of the Revenue Act of 1934, as applied by the Commissioner of Internal Revenue, to the facts presented was unconstitutional and void.

III.

In not finding that of the sum of $17,666.25 received by Maud Gillespie during the year 1935 from F. A. Gillespie and Sons that $15,000.00 represented payment to her under the contract of May 15, 1929, and $2,666.25 represented a loan made to her by the company.

IV.

In the alternative, if any part of the $15,000.00 payment is taxable to Maud Gillespie, then the amount which was

taxable could not exceed 3 per cent of the cost of acquiring an annuity upon the life of the taxpayer on May 15, 1929, which sum amounted to $196,537.50, three per cent of which would amount to $5,896.13; and in not finding that the $10,000.00 annual payment was donated back to F. A. Gillespie and Sons Company by Maud Gillespie under date of November 16, 1933.

Summary on the Argument.

An agreement, whereby an Oklahoma corporation, organized for the purpose of engaging in the oil business, promised and agreed to make future payment to the taxpayer during her life, was made in consideration of the transfer by her to such corporation of certain stocks and bonds and other property, which contract had no fair market value when received by the petitioner. And, if the cash payments received during the year in which the agreement was made did not exceed the cost basis of the stock, neither did the amounts received for the other years up to and including the year in question exceed the cost basis of the stock; then the taxpayer realized no taxable gain from the amount received in the year 1935.

Of the entire value of the property transferred by the petitioner not less than one-half the sum of $1,464,240.22, or $732,120.11, constituted a consideration paid for the sums received and to be received by her. The aggregate amount received by the petitioner up to December 31, 1934, was $79,894.01; hence, none of the payments received in 1935 could be taxable, as the taxpayer has recovered, by way of cash payments, scarcely more than 10 per cent of her cost in the property transferred.

The application of section 22 (b) (2) of the Revenue Act of 1934, as applied to the facts presented, was unconstitutional and void. The United States Board of Tax Appeals found that the taxpayer delivered securities having a

fair market value and a cost of not less than \$732,120.11 to the corporation, as consideration under the contract of May 15, 1929. In the enactment of section 22 (b) (2) of the Revenue Act of 1934, it obviously was the intent of Congress to attempt the levy of a tax upon annuities based upon 3 per cent of the cost on the supposition that an annuitant, receives at least that rate of interest return on the amount paid by the annuity.

The Board held that the taxpayer should be taxed on the amount of \$9,826.88 per year, that being 3 per cent of what an annuity would have cost which would have produced \$25,000.00 per year to the taxpayer. The taxpayer has actually been receiving \$15,000.00 per year, of which sum \$5,173.12 would be a return of capital upon the basis as determined by the Board of Tax Appeals.

Assuming, but not admitting, that the payments received might be classed as annuity payments, if Your Honors approve the decision of the Board, it would require the taxpayer 141½ years to recover her costs of the property delivered to the corporation, under the terms of the contract, in return for the payments which she is receiving. The taxpayer, who was 63 years old in 1935, would need to live to the ripe old age of 198½ years to recover her capital. Such an anomalous situation clearly demonstrates that either section 22 (b) (2) of the Revenue Act of 1934 is unconstitutional as applied in this case or that section 22 (b) (2) is not applicable in this case.

The Board erred in not finding that the \$10,000.00 annual payment was donated back to F. A. Gillespie and Sons Company by Maud Gillespie under the supplemental agreement of November 16, 1933. In the alternative, if it is found that any part of the \$15,000.00 payment made by the company in 1935 under the contract of May 15, 1929, is taxable to Maud Gillespie; then the amount which was tax-

able could not exceed 3 per cent of the cost of acquiring an annuity which would have produced that amount on May 15, 1929. The cost of acquiring such an annuity would not exceed the sum of $196,537.50, three per cent of which would amount to $5,896.13.

The Board in its opinion concedes the donative intent of the petitioner in donating to the corporation and to her children and grandchildren the remainder of the value of the property over the cost of an annuity as a gift or contribution for the benefit of those children and grandchildren. Would it not be as reasonable to perceive the donative intent of the petitioner on November 16, 1933, as on May 15, 1929? If the taxpayer was donating property in excess of the cost of a $25,000.00 annuity on May 15, 1929, could she not just as reasonably donate the additional value in 1933 when she entered into a new agreement relieving the company of the $10,000.00 dividend guarantee?

The Board erred in not finding that of the sum of $17,666.25, received by Maud Gillespie during the year 1935 from F. A. Gillespie and Sons Company, that $2,666.25 represented a loan made to her by the company. The Board found as a fact that the $2,666.25 represented a payment to her under the contract of May 15, 1929, and did not represent a loan made to her by the company, F. A. Gillespie and Sons Company, as contended by the taxpayer.

The member in writing the opinion admitted that the taxpayer overcame the presumption, that the determination by the Commissioner was correct, by holding that the sum of $17,666.25 was not entirely the proceeds of an annuity. The Commissioner made no determination with respect to the $2,666.25 except that it constituted an annuity payment. There is no evidence in the record, nor finding by the Commissioner, to support any other finding of fact than that the sum of $2,666.25 represented a loan made to the taxpayer by the company, F. A. Gillespie and Sons Company.

ARGUMENT.

I.

Of the sum of $17,666.25, $15,000.00 was paid pursuant to the contract of May 15, 1929, and constituted a part of the payment price for the purchase of assets.

The attention of your honors is directed to the agreement of May 15, 1929, between the taxpayer, Mr. Gillespie and F. A. Gillespie and Sons Company (R. 27). There were two considerations for the transfer of the property; one of which was the payment of $15,000.00 per year each to Mr. and Mrs. Gillespie, with an additional $10,000.00 per year dividend guarantee, which later was taken out from under the terms of the contract by the letter of November 11, 1933, and paragraph 2 of the contract, which reads as follows:

> "The husband agrees with the wife and with the corporation that the said F. A. Gillespie will not sell or transfer any of the corporate stock of the corporation now standing of record in the records of the corporation in accordance with the terms of the declaration of trust dated February 9, 1921, hereinabove referred to, *without the written consent so to do of a majority of the Board of Directors of the corporation.*" (Italics ours.)

Under the terms of the declaration of trust of February 9, 1921 (R. 11), F. A. Gillespie had the authority to sell or otherwise dispose of the stock of F. A. Gillespie and Sons Company as he saw fit. Under the trust agreement of February 9, 1921, Mr. Gillespie was holding 9,975 shares in trust out of the 10,000 shares authorized. The restriction placed on the sale of this stock under the terms of the trust agreement was undoubtedly a very valuable right and the surrender of it undoubtedly was worth a great deal to Mrs. Gillespie and to the corporation.

The intent of the parties is always to be considered when any question arises with respect to the construction

of a contract. It was the intent of Mrs. Gillespie to turn her property over to the corporation in consideration of the payment to her of $15,000.00 per year and any residue in excess of the amount which she received was turned in to the company for the benefit of her children and grandchildren (R. 71-73). Mrs. Gillespie, upon being questioned concerning the trust agreement and the property turned over to the corporation, made this statement:

> "Oh, yes, surely, I turned this over so that my sons and my grandchildren would benefit by it." (R. 71),

and at R. 72 (in her deposition) she again answered:

> "Well, I figured that was turned in to the company for the benefit of my children and my grandchildren."

She testified that she did not intend purchasing or acquiring an annuity on her life. At R. 73, she said:

> "Well, I made—I gave my property to the company to safeguard my children and my grandchildren."

After the payments to her were made during her lifetime, it was her intention to consider the remainder over as a gift or contribution to the corporation for her children and grandchildren. Upon being asked this question:

> "And do you consider the remainder of the value of this property as a gift or contribution to your children?",

she answered,

> "It was just a gift to my children and my grandchildren." (R. 73-74)

A. N. Murphy, an officer of the First National Bank and Trust Company of Oklahoma City for more than ten years, testified that he had examined the contract and that his bank had handled similar contracts covering the sale of personal property and oil and gas property in the State of

Oklahoma, and that such contracts were not unusual. At R. 106, Mr. Murphy testified:

> "By Mr. Rorschach:
>
> Q. Have you had experience with any other agreements similar to the agreement dated May 15, 1929, and marked Exhibit D, and attached to the petitioner's petition?
>
> Mr. Anderson: That is objected to as immaterial. The proper foundation has not been laid.
>
> The Member: Objection overruled.
>
> A. I have.
>
> By Mr. Rorschach:
>
> Q. What experience have you had with other agreements of a similar character, covering the sale of personal property and oil properties in the State of Oklahoma?
>
> Mr. Anderson: Objected to as immaterial.
>
> The Member: Objection overruled.
>
> A. They have been up in our discount department through matters of applications for loans. We have handled quite a few in our trust department, sometimes involved in a trust and sometimes in an escrow.
>
> Those are the direct experiences I have had with such matters."

Mr. Murphy also testified that such a contract had no fair market value and that it was highly speculative, because the payments of money provided would cease upon the death of one of the parties (R. 103, 106):

> "Q. I hand you an agreement dated the 15th of May, 1929, which is Exhibit D attached to the petitioner's petition, and ask you to examine same and state if similar agreements have been tendered to you, on behalf of your bank, evidencing the right of the grantor to receive income similar to this agreement?
>
> A. They have.
>
> Q. I ask you again to refer to the agreement which

is attached to the petitioner's petition, and marked Exhibit D, dated May 15, 1929, and ask you if you have an opinion as to whether or not your bank would make a loan to either F. A. Gillespie or Maud Gillespie, taking as collateral for the loan an assignment of the payments to be made to either F. A. Gillespie or Maud Gillespie?

Mr. Anderson: I object.

The Member: I think you are restricting it too much there. One bank might be willing to, and another bank might not be willing to.

Mr. Anderson: I will object on the other ground that it is immaterial.

The Member: I do not know whether it is or not. I will overrule the objection on that ground.

By Mr. Rorschach:

Q. Will you state whether you have an opinion as to whether your bank or any other commercial bank would or would not make a loan——

Mr. Anderson (interrupting): I object to that, your honor, as to his stating his opinion of what another bank would do.

The Member: What I had in mind was whether, as a banker, his experience, if any, gives him an opinion in the nature of an expert opinion as to whether such commercial paper would be deemed by the bank as collateral.

Mr. Anderson: I object, your honor. He has not been qualified to give an expert opinion.

Mr. Rorschach: He stated he was assistant trust officer of the First National Bank and Trust Company and has taken up matters similar to this contract with the discount committee of his bank, and identified the contract, and stated he examined a contract similar to this contract.

Of course, I will admit, your honor, some bankers may not be qualified, but I believe, your honor, most bankers generally are conceded to be.

The Member: That seems to be the point, whether his own bank would recognize it as a basis for loans.

By Mr. Rorschach:

Q. Let me ask you, Mr. Murphy: How long have you been with the First National Bank & Trust Company of Oklahoma City?

A. More than 10 years.

Q. In the last 10 years have you discussed contracts of this nature with national bank examiners, and examiners for the Federal Deposit Insurance Corporation?

A. I have.

Q. Have you an opinion, then, as to whether or not a so-called commercial loan could be based upon such a contract as this? That is, could such a contract be considered by a commercial bank as collateral security for a loan?

A. I have such an opinion.

Q. Will you state what that opinion is?

A. It would have no value for a commercial loan, not only in the bank I am associated with but other banks in this section of the country.

Q. Will you state the reason for that opinion?

A. It has no set value. It is speculative, because the payments of money provided there cease upon the death of the party.

Mr. Anderson: Just a minute. I would like the record to show, your honor, I am objecting to all this line of testimony as being immaterial.

The Member: Objection overruled. Exception allowed.

The Witness: I might say, further, I am satisfied that if they did make such a loan the national bank examiners would require them to charge it off.

Mr. Anderson: I move that that be stricken as hearsay.

The Member: I think it is within the scope of his qualifications. I will overrule the objection. He is stating his own opinion. He is not giving it as hearsay."

By the terms of the agreement of May 15, 1929, all of the property of Mr. and Mrs. Gillespie was transferred to the corporation, and the corporation agreed to pay for the property by the payment of certain specified sums annually to Mr. and Mrs. Gillespie. The transaction was concluded under the provisions of the Revenue Act of 1928, sections 44 (b), 111 (a) (c) and 113 (a), governing the transaction.

The contract of May 15, 1929, had no fair market value; hence, the sale of the bonds and other property was upon the deferred payment basis, and the amount received by the taxpayer in the year 1935 was covered by the applicable provision of the Revenue Act of 1934. Section 44 (b) of the act and the regulations promulgated thereunder provide that the payments received in cash should be applied against, and reduce, the basis of the property sold and that no gain should be realized until the cost basis of the property had been returned to the taxpayer.

The contention by the Commissioner of Internal Revenue that the amount received was an annuity payment and, hence, taxable under the provision of section 22 (b) (2) of the Revenue Act of 1934; and the approval of that finding in part by the Board is without support either in fact or law.

F. A. Gillespie and Sons Company, an Oklahoma corporation, had no authority to issue annuities or annuity insurance on May 15, 1929, or any other time.

The laws prevailing in the State of Oklahoma on May 15, 1929, and up to the present time, with respect to companies authorized to write insurance, etc., provide as follows:

36 Okl. St. Ann. 6:

"Ten or more persons may form a corporation for

the purpose of making any of the following kinds of insurance, to-wit:

"* * * *3.* Upon the lives or health of persons, and every insurance appertaining thereto, and to grant, purchase or dispose of annuities."

36 Okl. St. Ann. 8, provides as follows:

"No companies shall be formed in this State or foreign company admitted to this State for the purpose of engaging in any kind of insurance other than that specified in its certificate of incorporation, original or amended, nor any kind of business except that allowed domestic corporations under this article and in no instance other than that specified in some one of the subdivisions of section 3404, or more kinds of insurance than are specified in a single subdivision, except that a company may be formed: *(1)* for the purpose specified in subdivisions first, second and twelfth; *(2)* for the purposes specified in subdivisions third and fourth; or *(3)* for any or all of the purposes specified in subdivisions fourth to thirteenth, inclusive; contracts for each of the kinds of insurance specified in the subdivisions of section 3404, shall be in separate and distinct policies, except that the same policy may embrace risks specified in subdivisions third and fourth."

36 Okl. St. Ann. 3, provides as follows:

"From and after the passage and approval of this act, all contracts of insurance made and entered into by insurance companies, corporations, associations, joint stock companies or other persons not having first complied with the laws of the State of Oklahoma, by not having obtained a permit to transact insurance business within the State of Oklahoma from the Insurance Commissioner or the State Insurance Board of said State, shall be null and void, and no property owner or his agent in the State of Oklahoma, shall be liable to such insurance company, association or other person for the payment of any premium upon such contract or insurance and no action therefor may be maintained in any of the courts of this State."

If Your Honors hold with the Commissioner of Internal Revenue that the amount received by this taxpayer from F. A. Gillespie and Sons Company under the contract of May 15, 1929, is received pursuant to a contract of annuity insurance, then the contract is void.

It is submitted that Your Honors must indulge in the presumption that F. A. Gillespie and Sons Company would not violate the laws of the State of Oklahoma, the state in which it is chartered to do business, and attempt to write a contract which was in no wise authorized by its charter. Furthermore, if Your Honors hold that Mrs. Maud Gillespie had a contract of annuity insurance, such contract would be void and of no force nor effect.

An examination of the articles of incorporation of F. A. Gillespie and Sons Company (R. 127) plainly indicates that said corporation was chartered for the purpose of dealing in oil and gas leases, real estate and other manufacturing and mercantile pursuits. The property which it acquired by virtue of the contract of May 15, 1929, was the acquisition of property the same as any corporation might acquire property and pay for same upon a deferred or installment plan basis.

Witness Murphy (R. 103-108) stated that the agreement was no more than a sales contract or sales agreement of which his bank had handled several.

Of the sum of $17,666.25, $15000.00 was paid pursuant to the contract of May 15, 1929, and such sum is not an annuity.

Webster defines "annuity" as "an amount of money payable yearly for a certain or an uncertain period." The word "annuity" derives its meaning from the Latin word *"annuitas"* which is derived from the Latin *"annus,"* meaning year.

In *Solicitor's Opinion 160, Cumulative Bulletin III-2,* page 60, Solicitor of the Internal Revenue held:

> "An annuity is a stated sum payable at stated times during life or a specified number of years under an obligation to make the payments *in consideration of a gross sum paid for such obligation.*" (Italics ours.)

In this case, Mrs. Gillespie paid no gross sum under the terms of the contract, but transferred property such as stocks, bonds, real estate, etc. (See Stipulation of Facts, R. 94.)

In *Chisholm* v. *Shield*, 66 N. E. 93, the court said:

> "An annuity as understood in common parlance is an obligation by a person or a company to pay to an annuitant a certain sum of money at stated times during life or a specified number of years *in consideration of a gross sum paid for such obligation.*" (Italics ours.)

The British income taxing system was probably the most widely known system at the time of the adoption of the Sixteenth Amendment. The English usage therefore might give some indication as to what was deemed income and taxable under income tax acts. The British Act has always considered an annuity as income. The British judges have endeavored to prevent a harsh construction of the statute, by distinguishing the thing taxable as an "annuity" from other receipts resembling it and sometimes loosely termed "annuities."

In *Foley* v. *Fletcher,* 3 H. & N. 769, the plaintiff sold mining property at a named price to the defendant. He promised to pay the price in semi-annual installments running over some thirty years. The defendant deducted the income tax from the periodical payments, as he deemed the British laws required, and the plaintiff sued therefor and was met by a plea setting forth the purpose of the deduction. The court admitted that an annuity was expressly taxable but

concluded that Parliament had not intended to levy an assessment on capital and decided that the installments in question were capital and not taxable as annuities or otherwise.

Baron Watson formulated a definition of annuity, page 764:

> "An annuity means where income is purchased with a sum of money, and the capital has gone and ceased to exist, the principal being diverted into an annuity."

In *Secretary of State in the Council of India* v. *Scoble,* 2 K. B. 413 (1903), 1 K. B. 494 (1903), the facts are somewhat similar to the *Foley* case except that the contract termed the installments an annuity and each installment was stated to be composed of *(1)* a part payment of principal and *(2)* interest on unpaid principal. The court again held that the designation of the payment as an annuity by the contract did not make it in fact an annuity and that no tax could be exacted on the payment of the principal and that the tax could only be exacted on the amount paid as interest.

By the transfer of the property by Mrs. Gillespie to the corporation under the contract of May 15, 1929, it cannot be said that she purchased income with a sum of money and that the capital had gone and ceased to exist. While it is true that to some extent, Mrs. Gillespie has lost control of the property which she delivered to the corporation, she still retains her interest as a stockholder and her beneficial interest, consisting of a one-fifth interest in the corporation under the terms of the trust agreement of February 9, 1921. Also one element of a consideration of the contract of May 15, 1929, was the promise by F. A. Gillespie to refrain from disposing of any of the stock of F. A. Gillespie and Sons Company under the trust agreement of February 9, 1921. Thus, it can be seen that Mrs. Gillespie did not purchase an

annuity and that her capital has not gone and ceased to exist, in the sense as defined by Baron Watson.

By reference to the report on "*Prevention of Tax Avoidance,*"* and the *Report of the Committee on Ways and Means,* and the *Senate Report with Reference to the Revenue Bill of 1934* it can readily be seen that Congress had in mind the taxation of pure annuities purchased by persons from insurance companies and agencies engaged in the writing of this class of business; that is, the purchase of an annual income with a sum of money from an insurance or trust company engaged in writing that class of risks.

In "*Prevention of Tax Avoidance*"* the committee stated in its recommendations that "*some amount representing the portion of the annuity receipts consisting of interest be made subject to the income tax.*" (Italics ours.)

The report of the Committee on Ways and Means stated:

> "Payments to annuitants are, in fact, based upon mortality tables which purport to reflect a rate of return sufficient to enable the annuitant to recover his cost, and in addition thereto, a *low rate of return on his investment.*" (Italics ours.)

The Senate Report stated:

> "Payments to annuitants are, in fact, based upon mortality tables which purport to reflect a rate of return sufficient to enable the annuitant to recover his cost, and in addition thereto, *a low rate of return on his investment.*" (Italics ours.)

It is submitted to Your Honors that if the Board is upheld in its contention that the contract of May 15, 1929, is an annuity contract, then Your Honors are holding a contract taxable as an annuity contract which was not in con-

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*Preliminary report of a subcommittee of the Committee on Ways and Means, "Prevention of Tax Avoidance," submitted under date of December 4, 1933.

templation by Congress at the time of consideration of section 22 (b) (2).

Congress contemplated that an annuitant would at some time recover his cost. In the instant case, it is physically impossible for this taxpayer to recover her cost unless she lives to be 106 years of age.

The Board of Tax Appeals has previously held that an agreement providing for the sale of the interest of a deceased partner to surviving partners and the payment therefor upon an annual basis out of the proportion of the partnership profits, constituted a purchase of the capital assets and that there should be included in the net income of each of the surviving partners his distributable share of the amounts paid to the heirs of the deceased partner in accordance with the terms of the agreement. *Willard C. Hill* v. *Commissioner,* 14 B. T. A. 572.

We have a parallel situation in this case. Mr. and Mrs. Gillespie transferred certain assets to a corporation in which they held a controlling interest and in return had an agreement by the corporation to pay them certain annual payments in return for the assets. Certainly this transaction constituted a purchase of capital assets and the income from these acquired assets were taxable to the corporation. Funds which were used to pay for the assets over the period of years to Mr. and Mrs. Gillespie might come from any source, either income or capital. The purchase of these assets by the corporation was exactly on the same basis as they might purchase assets from anyone not a stockholder.

Congress contemplated that an annuitant would at some time recover his cost. Obviously, if this was not in contemplation by Congress, then section 22 (b) (2) would be unconstitutional and void. In the instant case, under the decision of the Board, the taxpayer is receiving $15,000.00 per year under the contract, of which $9,826.88 is considered in

this decision as income and $5,173.12 as a return of capital (R. 158). If it be considered that the taxpayer has an investment, as was found by the Board, in this "annuity" of $327,562.50, then it would require 63 years for the taxpayer to recover her "assumed" cost. If her actual cost be considered as one-half of $1,464,240.22, or $732,120.11, then it would require 141½ years for the taxpayer to recover her cost. She was 57 years of age when the agreement of May 15, 1929, was entered into; therefore, she would need to attain the age of 120 years in order to recover her "assumed" basis, or 198½ years to recover her actual basis. Obviously, such an assumed age is a physical impossibility.

The Board has held that in an agreement identical with the one here involved, whereby future payments were made to the taxpayer during his life in consideration of the transfer of certain personal property, that no taxable gain was realized until the cash payments received exceeded the cost basis of the stock. *J. Darsie Lloyd* v. *Commissioner,* 33 B. T. A. 903. In that case the father of Harold Lloyd, the famous comedian, owned 2,499 shares of stock in the Harold Lloyd Corporation. The cost basis in his hands on April 16, 1930, was $122,567.68, on which date he transferred the shares to his son, Harold Lloyd, pursuant to a written contract, the contract providing that Harold Lloyd should pay in consideration of the transfer of the shares the sum of $100,000.00 a year, payable quarterly, beginning on the first day of May, 1930, so long as both parties should live; and, in the event that Harold Lloyd should pre-decease his father, the estate would pay the sum of $50,000.00 per year, quarterly, during the remaining period of the father's life.

$75,000.00 was received during 1930 under this contract. In holding that the agreement for sale was on the basis of a deferred payment and that no taxable gain was realized until the cash payments exceeded the cost, the Board stated:

"The petitioner completely disposed of 2,499 shares of Harold Lloyd Corporation stock in 1930. The question is whether he realized from the transaction any gain taxable in 1930. Section 111 of the Revenue Act of 1928 provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis. The basis here has been stipulated. The amount realized is defined in section 111 (c) as 'the sum of any money received plus the fair market value of the property (other than money) received.' The petitioner received no money on April 16, 1930, when he parted with his stock. He received $75,000 in cash later in 1930 under the agreement. Unless the amount realized included property (other than money) having a fair market value, there was no taxable gain for 1930 from the transaction, since the cash did not equal the basis of $122,567.68. The petitioner received the promise of his son, Harold, expressed in the contract, to make certain annual payments of money in the future. Did that represent property having a fair market value within the meaning of section 111 (c)?

"The petitioner did not give his stock to his son. The transfer was supported by a valuable consideration, the promise and agreement to make payments in the future. We are not called upon to determine the cost of the stock to Harold, but rather to determine whether the petitioner received any property having a fair market value on April 16, 1930, upon which an immediately taxable gain should be computed. Sometimes it is necessary to determine a value for a certain tax purpose but not for another, and sometimes the two sides of a transaction do not receive parallel tax treatment. *Logan* v. *Commissioner,* 42 F. (2d) 193, and the same case affirmed by the Supreme Court, *Burnet* v. *Logan,* 283 U. S. 404; *Alexander D. Falck,* 26 B. T. A. 1359, affd., 71 F. (2d) 656, *certiorari* denied 293 U. S. 608. Cf. *Steinbach C.,* 3 B. T. A. 348; *John C. Moore Corporation,* 15 B. T. A. 1140; *Florence L. Klein,* 6 B. T. A. 617; *Scott* v. *Commissioner,* 29 F. (2d) 472; *Simpson* v. *United*

States, 252 U. S. 547. Where marketable exchangeable promises to pay are accepted as a part of a purchase price, their fair market value is included in the 'amount realized' and a taxable gain is realized immediately. Cf. *Ruth Iron Co.,* 4 B. T. A. 1151, affd. 26 F. (2d) 30; and *Kosmerl* v. *Commissioner,* 25 F. (2d) 87. But promises to make future payments do not always have an exchangeable value *(Eisner* v. *Macomber,* 252 U. S. 189) and are not always income when received. *Bedell* v. *Commissioner,* 30 F. (2d) 622; *Dudley T. Humphrey,* 32 B. T. A. 280. In such cases the actual payments as made are taxed as income when received in excess of the basis. The petitioner reported his profit in that way.

"The fair cost of an annuity based upon experience tables giving life expectancies can be determined by actuaries. A similar method would have to be used in order to estimate the present value of an annuity to the annuitant. But here a new element enters the computation, the uncertainty as to whether or not the one agreeing to make payments will be able to make them as agreed when the time for payment actually arrives. This difficulty might not be so great in the case of a sound insurance company regularly engaged in granting annuities, or perhaps, in the case of a bank. Cf. *Guaranty Trust Co. of New York, Executor,* 15 B. T. A. 20. Laws have been enacted to safeguard investors of such institutions. But that kind of an annuity is not involved in this case. Harold C. Lloyd was an individual. He was wealthy in 1930 but he was not engaged in the business of granting annuities, and his investments were not subject to restrictions and supervision as are those of insurance companies and banks. The evidence shows that the contract of April 16, 1930, whereby Harold C. Lloyd promised and agreed to make future payments to his father, the petitioner, had no fair market value within the meaning of section 111 (c) when received by the petitioner on April 16, 1930. Cf. *Helvering* v. *Louis,* 77 F. (2d) 386, reversing 29 B. T. A. 1200; *Commissioner* v. *Newbury,* 80 F. (2d) 631. The Commissioner erred in including any gain from the transaction in the petitioner's income for 1930."

We are confronted in this case with exactly the same situation with which the Board was confronted in the *Lloyd* case. The contract of May 15, 1929, had no fair value. F. A. Gillespie and Sons Company was not in the insurance business nor engaged in granting annuities. It was not under the supervision of any insurance commission. In fact, if the contract was an annuity or insurance contract, then F. A. Gillespie and Sons Company had violated the laws of the State of Oklahoma, and the contract under the provisions of 36 Okl. Stat. Anno. 3, was void and of no force nor effect.

Conversely, it has been held by the Board and many courts that the acquisition of property by the payment of annual amounts, or ''annuities,'' is an acquisition of capital assets for a stated purchase price and the annual payments are not deductible as interest on indebtedness, but only result in the postponement of the payment of the purchase price into the future. *Klein* v. *Commissioner,* 84 F. (2d) 310, 17 A. F. T. R. 1289; *Evans* v. *Rothensies,* District Court, Eastern District of Pennsylvania, Prentice-Hall, 1939, page 5.1193; *Scott* v. *Commissioner,* 29 F. (2d) 472; *Mastin* v. *Commissioner,* 28 F. (2d) 748; *Daniel Brothers* v. *Commissioner,* 28 F. (2d) 761; *Corbitt Investment Company* v. *Helvering,* 75 F. (2d) 525; *Steinbach Kresge Company,* District Court, District of New Jersey, 33 F. Supp. 899; *Denman Estate Company* v. *Commissioner,* 2 B. T. A. 633, I. T. 1242 1-1 C. B. 61, I. T. 1-2 C. B. 66.

Obviously there is no other conclusion which can reasonably be reached except that the sale was a deferred payment sale and no taxable profit could arise under any theory until the taxpayer had received the return of her cost basis. The cost basis being in excess of $700,000.00 and less than $100,000.00 having been returned up to date including the taxable year of 1935, no possible taxable profit could have accrued to the taxpayer.

II.

Section 22 (b) (2) of the Revenue Act of 1934, in so far as it purports to include in the petitioner's gross income for the year 1935 any portion of the payments received by her from F. A. Gillespie and Sons Company pursuant to the contract of May 15, 1929, during the year 1935 is arbitrary, capricious, unconstitutional, and void and purports to impose a direct tax on capital without apportionment among the states, according to population and contravenes the provision of article I, section II, clause 3, and of article I, Section IX, clause 4, of the Constitution of the United States and the provisions of the Fifth Amendment thereto.

Under the treatment accorded the payment made by F. A. Gillespie and Sons Company during the year 1935 by both the Commissioner of Internal Revenue and the United States Board of Tax Appeals, the tax liability for the year of 1935 depends upon the validity of section 22 (b) (2) of the Revenue Act of 1935. The entire value of the property transferred by the petitioner, which was not less than one-half of the sum of $1,464,240.22, or $732,120.11, constitutes a consideration paid for the sums received and to be received by her; of which amount $94,894.01 received by the petitioner up to and including December 31, 1935, will not equal the consideration paid under the agreement of May 15, 1929; and none of the payments received in 1935 would be taxable, unless section 22 (b) (2) of the Revenue Act of 1934 is valid.

Legislative history of section 22 (b) (2) of the Revenue Act of 1934 shows that the 3% basis was the adoption of an arbitrary rule.

Up until the enactment of the 1934 Revenue Act, payments received by annuitants from annuity contracts were not considered taxable until the entire cost or consideration paid for the annuities had been recovered by the annui-

tant. In the urge to secure additional revenue, Congress enacted section 22 (b) (2) of the Revenue Act of 1934, which purports to levy a tax upon annuities upon the theory that the receipt from all annuities are, as a matter of fact part interest and part return of capital. Congress adopted the arbitrary rule that 3% of the amount paid for the annuity should be deemed to be interest, and therefore income.

In the preliminary report of a subcommittee of the Committee on Ways and Means, *"Prevention of Tax Avoidance,"* submitted under date of December 4, 1933, at page 13 there appears a statement with respect to annuities:

> "PART II. *Minor Problems*—(1) *Annuities.* Section 22 (b) (2) of the Revenue Act of 1932 provides for taxing annuities, but not until the total amounts received exceed the total amount paid for the annuity.
>
> "Your subcommittee is of the opinion that the tax on annuity receipts to the extent that they represent income should not be postponed as permitted by present law. Such receipts are, as a matter of fact part interest and part return of capital. Therefore, it is recommended that some amount representing the portion of the annuity receipts consisting of interest be made subject to the income tax. In order to facilitate administration, it is recommended that *an arbitrary rule be adopted that 3 per cent of the amount paid for the annuity shall be deemed to be interest. This rule is applied only to annuity contracts."* (Italics ours.)

The report of the Committee on Ways and Means contains the following explanation of the purpose of the new 3% provision:

> "Section 22 (b) (2). *Annuities, etc.* The present law does not tax annuities arising under contracts until the annuitant has received an aggregate amount of payments equal to the total amount paid for the annuity. Payments to annitants are, in fact, based upon mortality tables which purport to reflect a rate of return suffi-

cient to enable the annuitant to recover his costs and in addition thereto a low rate of return on his investment. The change continues the policy of permitting the annuitant to recoup his original cost tax-free but requires him to include in his gross income a portion of the annual payments in an amount equal to 3 per cent of the cost of the annuity. *While the per cent used is arbitrary, it approximates the rate of return in the average annuity.* (Italics ours.)

"Statistics show that an increasing amount of capital is going into the purchase of annuities, with the result that income taxes are postponed indefinitely. The change merely places the return of this form of investment on the same basis as other forms of investment by taxing that portion of each payment which in fact constitutes income."

The Senate report to accompany the Revenue Bill of 1934 had this to say about annuities:

"Section 22 (b) (2). *Annuities.* The present law does not tax annuities arising under contracts until the annuitant has received an aggregate amount of payments equal to the total amount paid for the annuity. Payments to annuitants are, in fact, based upon mortality tables which purport to reflect a rate of return sufficient to enable the annuitant to recover his cost, and in addition thereto, a low rate of return on his investment.

"The House bill continues the policy of permitting the annuitant to recoup his original cost tax-free but requires him to include in his gross income a portion of the annual payments in an amount equal to 3 per cent of the cost of the annuity. While your committee is in agreement with the change made by the House, it was thought advisable to continue the policy of not taxing any portion of payments received from an annuity until the aggregate amount of payments equal the total amount paid for the annuity in cases where the aggregate amount received by the annuitant from all his annuities is not more than $500. * * * "

Thus it can be seen that the enactment by Congress of this section of the law into the Revenue Act of 1934 was merely an "arbitrary rule" that was adopted by it that 3% of the amount paid for an annuity should be deemed to be interest and hence taxable income.

It is submitted to your honors that judicial notice should be taken of the well known situation prevailing at this time and that has prevailed for the last several years. The United States Government is able to borrow money for less than 2% and the assets of most insurance companies are largely invested in United States Government bonds of this character. Annuities paid by insurance companies as a matter of fact cannot be presumed to be derived 3% from earnings and the balance as a return of capital.

It is quite apparent from the congressional discussion had by the senators at the time of the adoption of the section that Congress had in mind to tax only *the income derived as a part of each annuity payment.* Three per cent was an arbitrary amount then fixed by Congress, it being said that most annuities were calculated upon a basis of mortality tables and a return of 3% on the amount paid in to the insurance company by the annuitant. A study of insurance companies and their computations were used in arriving at the basis set forth in section 22 (b) (2) of the act. Quoting Mr. Harrison from the Congressional Record, volume 78 at page 5847:

> "Under the existing law no tax is imposed upon the recipient of an annuity until he has received back the entire amount paid for it. *Since an annuity represents in part interest upon the consideration paid, it seems fair to tax the annuitant currently upon the proportion of the annuity payment which represents interest*, and the bill so provides." (Italics ours.)

Mr. Reed stated at pages 5910-11, Congressional Record, volume 78:

"When insurance companies figure the amount that can be paid annually on annuity contracts, they calculate, *first,* the rental value of the principal during each year. Then, according to the expectancy of life of the individual, they compute how much of the principal can be returned to the annuitant, based on that expectancy. Their calculations involve, *first,* the interest on the money; *second,* return of principal during the balance of the probable life of the individual.

"In Great Britain the whole amount of such annuities is taxed as income. It did not seem fair to the Treasury—and this suggestion comes from the Treasury—*to tax that part of the annuity which represents the return of principal, but it did seem fair, and it seemed to the committee that it would stop a most important loophole, to tax that part of the annuity which represents interest on the capital.* That factor is generally computed by the insurance companies at 4 per cent, but obviously, since the principal is diminishing a little each year, it would be unfair to tax every year 4 per cent of the original principal, because that would be more than the remaining principal after the expiration of 2 years.

"*Consequently the Treasury, in the effort to reach a fair mean, has fixed on the figure of 3 per cent.* That is less than the interest return on the money in the early years, and it is probably more than the interest return toward the later years of the annuity. *That is the way the arbitrary 3 per cent was arrived at* * * *." (Italics ours.)

Mr. Herbert said at page 5913 of the Congressional Record, volume 78:

"Then, there is another objection to the recommendation of the committee, as I see it. The bill provides that *the total premium shall be assumed to yield an income of 3 per cent,* and that such income shall be reported each year for tax purposes, and there is no provision for the reduction which takes place in that income from year to year, but the annuitant must report 3 per

cent of his entire premium throughout his life. Assuming that an annuitant has paid a premium of $10,000 and received back a payment of $1,000 per year, at the end of 10 years he has received back his $10,000, and his entire principal is used up. Notwithstanding that, under the provision recommended by the committee, it is still assumed that the entire amount of the principal, $10,000, is in existence, and he is required to report income of 3 per cent of that $10,000.'' (Italics ours.)

Again at page 5915 of the Congressional Record, volume 78, Mr. Herbert observed:

''Suppose the Senator purchases for $100,000 a home which he occupies himself. That $100,000 will not yield him any income, but the Government has essayed to claim that a fair rental value of that house should be reported as income. The court said, 'No; that is not income. There has been no income. It is true that because the owner occupies his own home and does not have to pay rent elsewhere he saves that charge; but it is not income, and it is not income for tax purposes.' So in the case of the annuity the man deposits $100,000 for a specific purpose. *It is not income for him to have paid back to him the sum which he deposits.* (Italics ours.)

''Suppose the payment shall stop, as it might well stop, after he had received his principal. Could there be said to have been any income there? Yet, in many many cases that is true. Not only is that true, but many times the payment stops before he has received back his principal, to say nothing about income.''

At pages 5916 and 5918, Congressional Record, volume 78, Mr. Austin remarked:

''Suppose I have made a payment for an annuity today and receive but one annuity and then die; there is no provision in the bill whatever for a deduction on account of the large loss.

''If we take the example given by the Senator from Rhode Island, of the payment of $100,000 in the pur-

chase of an annuity contract and a return of only $10,-000 and thereupon the death of the annuitant, we can readily see that there has been an absolute total loss of $90,000, which is not recognized in any way whatever by this measure, although the entire theory of all our income-tax laws has been to recognize and to allow a deduction for actual realized losses.

"Mr. President, for these two reasons, *first, that this bill undertakes to tax a profit which is not yet realized,* and for the reason that it does not allow a deduction for a loss which is realized, *the measure is unjust and unfair, and ought not to be passed.* * * *

"It is true that when a person dies before the profits are realized his estate has suffered a loss. I made this statement previously, and I want to put into the record something which represents the opinion of the United States Board of Tax Appeals of very recent date.

"I refer to the case of Cora K. Louis, petitioner, against Commissioner of Internal Revenue, respondent, Docket No. 49179. Promulgated February 23, 1934." (29 B. T. A. 1200.) (Italics ours.)

Mr. George stated, at page 5920 of the Congressional Record, volume 78:

"I know, and I have the utmost confidence that the courts will be able to say that *when an insurance company writes an annuity contract* and when citizen A or B or C buys that contract, both of them, contemplating the contract that is about to be purchased, figure on an increase over and above the actual money outlay for that contract, and, therefore, that the Government may properly say it will consider a small percentage—3 per cent, in this case—on the actual money spent for the contract as gross annual income, to be added to the income of the taxpayer for the purpose of taxation, if the particular taxpayer is liable to pay an income tax." (Italics ours.)

It is submitted to Your Honors that the payments received under the terms of the contract do not come within

the purview of section 22 (b) (2) of the Revenue Act of 1934 and that no application of said section was ever intended by Congress with respect to payments made by virtue of a contract of the character here under consideration. Obviously it was the intent of Congress to attempt the levy of a tax upon annuities based upon 3% of their cost on the theory that an annuitant receives *at least* that rate of interest return on the amount paid for the annuity.

In this case, that cannot be true and the application of section 22 (b) (2) of the Revenue Act in the instant case would be an unconstitutional and unwarranted application and the taking of taxpayer's property.

Taxpayer turned over her portion of the property on May 15, 1929, to the corporation which had a value of not less than $732,120.11. Up to the end of the year 1935, she had received $94,894.01. At the rate of $15,000 per year, petitioner would require the elapse of forty-three years in which to recover only her capital, taking into account no earnings whatsoever. Petitioner was a woman of 63 years of age in 1935 and would need to live to the ripe old age of 106 years to recover her capital. Such an attained age is a physical impossibility. Obviously, taxpayer can never receive 3%, nor even a fraction of a per cent of return on her investment. Such a contract was not under consideration by Congress and it was never intended by Congress to pass a law such as would lay a capital levy, as would be done in this case if Your Honors approve the decision of the Board of Tax Appeals.

A taxpayer may not be taxed upon some fictitious or hypothetical income basis nor upon something alleged by the Commissioner to be income which is in fact not income. *Richard* v. *Commissioner,* 111 F. (2d) 376; *Hillman* v. *Commissioner*, 71 F. (2d) 688, 14 A. F. T. R. 318.

No part of the payments received by taxpayer under the contract of May 15, 1929, constitutes income until the aggregate of the amounts received equals the cost or value of the property transferred and until then, the whole amount received constitutes a recovery of a portion of the taxpayer's capital.

Income, as used in the Sixteenth Amendment, has been considered by the Supreme Court in *Eisner* v. *Macomber,* 252 U. S. 189, 64 L. ed. 521:

> "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle* case."

In *Doyle* v. *Mitchell Bros.,* 247 U. S. 179, 62 L. ed. 1054, it was stated:

> "In order to determine whether there has been gain or loss, and the amount of gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

The Board of Tax Appeals, in *Independent Life Insurance Company of America* v. *Commissioner,* 17 B. T. A. 757, at page 771, held as follows:

> "There must be some sort of consummated pecuniary gain from which the tax can be paid."

In the case of this taxpayer, there can be no gain until the entire cost is recovered. She had received the sum of $94,894.01 up to December 31, 1935. The property which she delivered to the company pursuant to the contract had a value of not less than $732,120.11.

This taxpayer was born June 9, 1872, and is now 69 years old. To recover the balance of her capital at the rate

of $15,000.00 per year, she would need to live to the ripe old age of 106 years. The total amount which will be received depends entirely upon the length of the taxpayer's life and that is wholly unpredictable.* Until this taxpayer has actually received her total cost, it cannot be known whether she will ever do so and until it is reasonably certain that the capital will be recovered, then there certainly can be no gain. Therefore, a tax on any part of the amount received before the recovery of the total cost is a *tax on capital.*

Where the total amounts to be received are uncertain or contingent, the first payments are wholly a return of capital. *Commissioner of Internal Revenue* v. *Spire,* 77 F. (2d) 824; *Helvering* v. *Drier,* 79 F. (2d) 501; *Virginia Coal and Coke Company* v. *Commissioner,* 99 F. (2d) 919; *Florence M. Quinn* v. *Commissioner,* 35 B. T. A. 412; *Heiner* v. *Mellon,* 89 F. (2d) 141.

In *Thomas A. O'Donnell,* 25 B. T. A. 959, the taxpayer had sold his stock in an oil company for the right to receive a share of the subsequent net profits from the company's property, and at page 961, the Board said:

> "It was a sale of property which might or might not give rise to income, depending upon the inscrutable factor of future oil production. If and when petitioner had received back his capital cost or base, income would begin to accrue. If such cost were never recovered, no income would ever arise. *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179."

In *Burnett* v. *Logan,* 283 U. S. 404, 75 L. ed. 1143, the Supreme Court in effect declared that the general rule above noted in the various cases applied to annuities. In the *Burnett* case, the taxpayer owned stock in a corporation which entitled her to receive a portion of the ore mined by another corporation. She sold her stock for cash, and in addition a

*Taxpayer has died since this appeal perfected.

promise by the buyer to pay in the future 60c per ton of ore received by it by virtue of its ownership of the stock.

The Commissioner held that the obligation of the buyer to make the tonnage payments had a fair market value at the time of the sale and should be treated as a closed transaction. The Commissioner's value of the buyer's obligation was based upon an estimate of ore reserves and an assumption that the total ore would be mined in equal annual quantities during the succeeding forty-five years. The Commissioner used that valuation as a basis for apportioning subsequent annual receipts between income and the return of capital.

The aggregate payments received by the taxpayer during the year involved included the original cash down payment and the subsequent tonnage payments were less than the cost basis of the stock sold. Taxpayer claimed that until the total amount actually received by her should equal her cost basis that no part of the payments was taxable. The Board of Tax Appeals upheld the Commissioner, the Circuit Court of Appeals, however, holding that it was impossible to determine the market value of the buyer's obligation and the taxpayer was entitled to the return of her capital before being charged with any taxable income. The decision of the Circuit Court was affirmed by the Supreme Court and it was said at page 412:

> "As annual payments on account of extracted ore come in they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation. When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000.00 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense

equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. Prior to 1921 all receipts from the sale of her shares amounted to less than their value on March 1, 1913. She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture.

" 'In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.' *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 184, 185."

The Supreme Court evidently believed that the same plan should be applied to annuities for in the *Burnett* case, the court said, at page 414:

"If a sum equal to the value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment. *We think a like rule should be applied here.*" (Italics ours.)

The obvious reason why payments under an annuity contract would have been free from income tax until the owner has recouped his capital investment is because until then such payments are wholly a return of capital and no part of them can constitute income.

All of the foregoing decisions holding that the first receipts are wholly exempt from tax until the recoupment of the capital did not rest upon specific exemption provisions of the revenue acts, but upon the inherent nature of the payments as a return of capital and not income.

Congress cannot transform capital into income by mere legislative fiat. *Eisner* v. *Macomber,* 252 U. S. 189, 64 L. ed. 521; *Burk-Waggoner Oil Association* v. *Hopkins,* 269 U. S.

110, 70 L. ed. 183; *Taft* v. *Bowers,* 278 U. S. 470, 73 L. ed. 460.

In *Taft* v. *Bowers,* the court said at page 481:

> "Under former decisions here, the settled doctrine is that the Sixteenth Amendment confers no power upon Congress to define and tax as income without apportionment, something which theretofore could not have been properly regarded as income."

The 3% provision of the Revenue Act causes the imposition of a tax on estimated average income without regard to actually taxing the capital of one annuitant in order to collect a tax on another annuitant's future income before its receipt. Previous revenue acts ultimately taxed all income received from annuities. The 3% provision of the 1934 Revenue Act likewise taxes all income received in excess of cost, *by those who recover their total cost;* however, the new provision also taxes part of the annuity payments received by those annuitants who never recover their cost.

In the case of this taxpayer she would never be permitted to recover *any part* of her cost if the contention of the Commissioner of Internal Revenue be approved by this Honorable Court. The Commissioner says that because 3% of the cost is in excess of the amount received that the entire amount is taxable. A fallacious argument indeed! By this treatment there is proposed a levy upon capital, a direct tax and not an income tax.

The supposed evil that Congress was attempting to remedy in the new provision was not that any income from annuities formerly escaped taxation, but merely that the collection of the taxes was postponed until the income was determined and received. Quoting from "*Prevention of Tax Avoidance,*" *supra:*

> "Your Committee is of the opinion that the tax on annuity receipts to the extent that they represent in-

come, *should not be postponed, as permitted by present law.*" (Italics ours.)

Solely in order to prevent this delay in the collection of the tax from those annuitants who will subsequently receive income, Congress now attempts to tax all annuitants regardless of their cost, or regardless of their situation. Many of these will never receive any income whatever. The estimated average rate (estimated in the year 1933) of income from annuities is made an arbitrary minimum rate, without any corresponding maximum.

This is analogous to taxing all men who are seven feet tall on the basis of the income received by one as a sideshow freak, on the theory that all men seven feet tall are freaks and ought to receive the same as some selected member of the group; or taxing all persons who have $100,000.00 worth of property on the basis of $3,000.00 per annum on the theory that at least each ought to secure a 3% return per annum on his capital, irrespective of the type of investment, the management ability of each, or the time expended in managing the investment.

We believe that it would be conceded that such a tax would be unconstitutional and void and not within the purview of the Sixteenth Amendment. The effect of the change in the 1934 Act is not only to advance the time of the collection of the tax from future income before the income is received but also to tax a portion of the annuity payments where no income will ever be received. Income tax cannot be imposed on prospective income.

The law contemplates that it be either accrued or received, actually or constructively. Otherwise no tax can attach. Income tax may not be imposed on the basis of average income received by all taxpayers, but only upon the income which the particular taxpayer has in fact received.

In *Hoeper* v. *Tax Commissioner,* 284 U. S. 206, 76 L. ed. 248, the court said:

> "We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the Fourteenth Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income. Compare *Nichols* v. *Coolidge,* 274 U. S. 531, 540."

In the 1934 Revenue Act, Congress is attempting to measure the tax on one annuitant's income by reference to the income of another annuitant.

The fact that a large amount of capital may have been disposed of in such a manner that the receipt therefrom is postponed, does not authorize or empower Congress to retaliate by taxing that capital on an assumed or fictional basis. If the purchase of annuities postponed the receipt of income from that capital, the collection of an income tax must necessarily be postponed until some actual income is determined and received. Congress cannot tax income which might have been, but was not actually received or accrued. The power which Congress attempts to exercise in this 3% provision has never before been upheld. If this principle is now sustained, where will its application stop?

Your Honors will take judicial notice that a vast storehouse of capital is lying idle in banks, producing no income. The Treasury is thus deprived of taxes on the income which that capital might produce if invested. Can Congress require that 3%, or any percentage, of all idle funds be included in gross income on the theory that that amount approximates the rate of return from the average investment of capital?

The Supreme Court has rejected the theory that income tax can be imposed upon the average basis or upon a conjectural basis in order to avoid delay in its collection. In *Burnett* v. *Logan, supra,* the court said:

> "As annual payments on account of extracted ore come in, they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation. *When the profit, if any, is actually realized, the taxpayer will be required to respond.*" (Italics ours.)

It is submitted to Your Honors that until this taxpayer has received her cost that no income has been received, either actually or constructively, nor has any accrued, and therefore there is nothing upon which the income tax statute can operate. The argument of the Commissioner of Internal Revenue certainly cannot bear close scrutiny that the full amount of $17,666.25 received by this taxpayer is taxable for the reason that it is less than 3% of the amount paid to the company by virtue of the contract of May 15, 1929.

In other words, the Commissioner of Internal Revenue in effect is saying that if a taxpayer makes a bad deal, which results in no profit, that he is to be taxed regardless, because he should have made a deal which should have resulted in profit, in order that the income tax law might become operative and the Treasury collect some tax.

In the case of *F. A. Gillespie* v. *Commissioner,* 38 B. T. A. 673, with respect to the 3% of the cost of an annuity being considered as income, in reply to the contention that it was an unreasonable allocation, Member Disney said that it conformed to "*what the legislative body believed to be the income ordinarily realized by the annuitant.*" (Italics ours.)

If this be the measure of the authority of Congress to legislate for fiscal purposes, then indeed all constitutional

restraint has gone with the wind and we have neither rules nor land-marks by which to be guided, except what the legislative body at any given time believes to be the average income ordinarily received by a taxpayer.

If the Commissioner of Internal Revenue is correct in his interpretation of section 22 (b) (2) of the Revenue Act of 1934 and Congress had the constitutional authority to enact that statute, then the Commissioner of Internal Revenue is acting in an arbitrary and capricious manner when he proposes to assess a tax upon an income of less than the 3% provided.

In the instant case, the Commissioner proposed to include the sum of $17,666.25 in taxpayer's gross income, whereas 3% of the value of the property turned over to the corporation would be not less than $21,963.60. If the Commissioner of Internal Revenue has authority to reduce the amount taxable to less than 3% of the cost, then he is arrogating unto himself legislative authority. An anomalous situation, indeed, where the taxpayer is assessed upon income of more than the gross amount actually received.

It is submitted to Your Honors that Congress had no intention of delegating authority to the Commissioner of Internal Revenue to juggle taxpayer's gross income about to please himself. Neither did Congress have in mind to tax, under section 22 (b) (2) of the Revenue Act of 1934, payments made pursuant to a contract of the character involved in this case. Conceding that section 22 (b) (2) of the Revenue Act of 1934 may be constitutional, the manner in which the Commissioner of Internal Revenue has sought to impose income tax upon this petitioner is arbitrary and capricious and not within the purview of section 22 (b) (2). If Your Honors hold that the Commissioner's act is within the purview of section 22 (b) (2) of the Revenue Act of 1934, then in the present case, that section is unconstitutional in so far

as it attempts to levy an income tax upon this taxpayer with respect to the amount received during the calendar year 1935 by virtue of the terms of the contract of May 15, 1929.

A provision of a Revenue Act, attempting to impose an income tax on capital, contravenes the provisions of article I, section 2, clause 3, and of article I, section 9, clause 4, of the Constitution of the United States; and a provision attempting to impose a tax upon the basis of averages, or of speculation and conjecture, without regard to actualities, is arbitrary and capricious, and contravenes the due process clause of the Fifth Amendment.

In *Eisner* v. *Macomber,* 252 U. S. 189, 64 L. ed. 521, holding that a provision of a revenue act imposing an income tax on stock dividends was unconstitutional as a tax on capital not apportioned among the states, the court said, at page 205:

> "The Sixteenth Amendment must be construed in connection with the taxing clauses of the original Constitution and the effect attributed to them before the amendment was adopted. In *Pollock* v. *Farmers Loan & Trust Co.,* 158 U. S. 601, under the Act of August 27, 1894, C. 349, paragraph 27, 28 Stat. 509, 553, it was held that taxes upon rents and profits of real estate and upon returns from investments of personal property were in effect direct taxes upon the property from which such income arise, imposed by reason of ownership; and that Congress could not impose such taxes without apportioning them among the states according to population, as required by Art. I, section 2, clause 3, and section 9, clause 4, of the original Constitution.
>
> "Afterwards, and evidently in recognition of the limitation upon the taxing power of Congress thus determined, the Sixteenth Amendment was adopted, in words, lucidly expressing the object to be accomplished: 'The Congress shall have power to lay and collect taxes on

> incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.' As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which might otherwise exist for an apportionment among the states of taxes laid on income. *Brushaber* v. *Union Pacific R. R. Co.,* 240 U. S. 1, 17-19; *Stanton* v. *Baltic Mining Co.,* 240 U. S. 103, 112, *et seq.; Peck & Co.* v. *Lowe,* 247 U. S. 165, 172-173.
>
> "A proper regard for its genesis, as well as its very clear language, requires also that this amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts."

The 3 per cent provision of section 22 (b) (2) of the 1934 Act imposes a tax on capital not apportioned among the states and is therefore unconstitutional.

The 3 per cent provision is also capricious and arbitrary, and contrary to the Fifth Amendment.

In *Schlesinger* v. *Wisconsin,* 270 U. S. 230, 70 L. ed. 557, the court said, on page 240:

> "The presumption and consequent taxation are defended upon the theory that, exercising judgment and discretion, the legisalture found them necessary in order to prevent evasion of inheritance taxes. That is to say, 'A' may be required to submit to an exactment forbidden by the Constitution if this seems necessary in order to enable the state readily to collect lawful charges against 'B.' Rights guaranteed by the Federal Constitution are not to be so lightly treated; they are superior to this supposed necessity. The state is for-

bidden to deny due process of law or the equal protection of the laws for any purpose whatsoever."

In *Heiner* v. *Donnan,* 285 U. S. 312, 76 L. ed. 772, in holding unconstitutional a provision of a revenue act taxing every transfer made within two years before death, as a gift made in contemplation of death, without regard to the facts, the court said, on page 325:

> "A statute which imposes a tax upon an assumption of fact which the taxpayer is forbidden to controvert, is so arbitrary and unreasonable that it cannot stand under the Fourteenth Amendment.
>
> "Nor is it material that the Fourteenth Amendment was involved in the *Schlesinger* case, instead of the Fifth Amendment, as here. The restraint imposed upon legislation by the due process clauses of the two amendments is the same. *Coolidge* v. *Long,* 282 U. S. 582, 596. That a federal statute passed under the taxing power may be so arbitrary and capricious as to cause it to fall before the due process of law clause of the Fifth Amendment is settled. *Nichols* v. *Coolidge,* 274 U. S. 531, 542; *Brushaber* v. *Union Pac. R. Co.,* 240 U. S. 1, 24-25; *Tyler* v. *United States, supra,* p. 504."

After discussing the effect of the statutory provision in question, the court further said, on page 327:

> "Plainly, this is to measure the tax on A's property by imputing to it in part the value of the property of B, a result which both the *Schlesinger* and *Hoeper* cases condemn as arbitrary and a denial of due process of law. Such an exaction is not taxation but spoilation. 'It is not taxation that government should take from one the profits and gains of another. That is taxation which compels one to pay for the support of the government from his own gains and of his own property.' *United States* v. *Railroad Co.,* 17 Wall. 322, 326."

Similar expressions are contained in *Nichols* v. *Coolidge,* 274 U. S. 531, 542, 71 L. ed. 1184, and *Hoeper* v. *Tax Commission,* 284 U. S. 206, 215, 76 L. ed. 248.

From the foregoing decisions it is plain that Congress had no power to tax the petitioner, nor to delegate to the Commissioner of Internal Revenue the authority to compute a fictional basis for taxation, upon the assumption that she received income at an arbitrary rate "approximating the rate of return in the average annuity," without regard to the actual facts.

III.

In any event no more than $15,000.00 was received by Maud Gillespie during the year 1935 from F. A. Gillespie and Sons Company under the terms of the contract of May 15, 1929, the remaining amount, $2,666.25, being a loan to the taxpayer from F. A. Gillespie and Sons Company.

In the letter of final determination sent to the taxpayer by the Commissioner of Internal Revenue, under date of March 2, 1939 (R. 10), it was determined by the Commissioner that the taxpayer received during the taxable year 1935 the sum of $17,666.25 from annuities.

The Board held in its decision that the taxpayer acquired two annuities, one paying $15,000.00 and the other, $10,000.00, per annum, and that the $10,000.00 per annum annuity had been turned back to the company by the letter agreement of November 16, 1933 (R. 118), which was effective during the year 1935.

Having thus concluded that the Commissioner was in error in his determination, it was then incumbent upon the Board to determine from the evidence the correct amount received by the taxpayer under the contract of May 15, 1929. Thus, the Board having concluded that the Commissioner was in error, there was no presumption attaching to any part of the determination of the Commissioner that his determination was correct.

If the petitioner's evidence goes so far as to show clearly and distinctly a determinating fact which establishes that the Commissioner's determination is incorrect and the proofs remain unchallenged, there is no presumptive validity of the Commissioner's rulings. *O'Rear* v. *Commissioner,* 80 F. (2d) 473; *Mount* v. *Commissioner,* 48 F. (2d) 550; *Lunsford* v. *Commissioner,* 62 F. (2d) 741; *Helvering* v. *Taylor,* 293 U. S. 507, 55 S. Ct. 287.

In the *Lunsford* case, the court said:

> "We have repeatedly held that the taxpayer has made out his case when he has put in proofs, 'clearly and distinctly tending to show' a determinating fact. *Rookwood Pottery Company* v. *Commissioner,* (C. C. A.) 45 F. (2d) 43; *Pioneer Pole and Shaft Company* v. *Commissioner,* (C. C. A.) 55 F. (2d) 861. The presumption that the Commissioner is right is procedural and cannot survive such proofs unless they are challenged by contrary proofs, or destructive analysis, and we have gone so far as to say that the taxpayer's affirmative evidence may itself contain the necessary challenge and furnish the material for such analysis. *Crowell* v. *Commissioner,* (C. C. A.) 62 F. (2d) 51, decided December 6, 1932. There is nothing of that sort here. There are no contrary proofs, and no reasonable inference can be drawn from the taxpayer's proofs to support the respondent's position. The record is clear that the payment to the taxpayer was a gift. The holding of the Commissioner and the Board to the contrary is clearly arbitrary, and must be set aside."

In the *Helvering* v. *Taylor* case, the Supreme Court, speaking through Mr. Justice Butler, stated:

> "We find nothing in the statutes, the rules of the Board or our decisions that gives any support to the idea that the Commissioner's determination shown to be without rational foundation and excessive will be enforced unless the taxpayer proves he owes nothing or, if liable at all, shows the correct amount. While decisions of the lower courts may not be harmonious, our

attention has not been called to any that persuasively supports the rule for which the Commissioner here contends.

"Unquestionable the burden of proof is on the taxpayer to show that the Commissioner's determination is invalid. *Lucas* v. *Structural Steel Co.,* 281 U. S. 264, 271, 50 S. Ct. 263, 74 L. ed. 848; *Wickwire* v. *Reinecke,* 275 U. S. 101, 105, 28 S. Ct. 43, 72 L. ed. 184; *Welch* v. *Helvering,* 290 U. S. 111, 115, 54 S. Ct. 8, 78 L. ed. 212. Frequently, if not quite generally, evidence adequate to overthrow the Commissioner's finding is also sufficient to show the correct amount, if any, that is due. See, e. g., *Darcy* v. *Commissioner,* (C. C. A.) 66 F. (2d) 581, 585. But, where as in this case, the taxpayer's evidence shows the Commissioner's determination to be arbitrary and excessive, it may not reasonably be held that he is bound to pay a tax that confessedly he does not owe, unless his evidence was sufficient also to establish the correct amount that lawfully might be charged against him."

Miss Ruth Reynolds, assistant secretary of F. A. Gillespie and Sons Company, testified (R. 125) that in 1935 the company paid Mrs. Gillespie the sum of $15,000.00 on the contract and $2,666.25 as a loan. On cross examination, the nature of this payment was most clearly brought out by the attorney for the Commissioner. The testimony on cross examination at R. 140 being as follows:

"By Mr. Anderson:

Q. You stated on direct examination that Mrs. Gillespie received from Gillespie & Sons $17,666.25 during 1935, the year at issue here, of which amount $2,666.25 represented a loan. Does the corporation's records disclose that this amount is a loan outstanding? In other words, is it listed as a loan receivable or an account receivable on the corporation's books?

A. It is not.

Q. What is the basis for your statement that this amount was a loan?

A. The information given me by Mr. P. A. Gillespie at the time the money was advanced.

Q. Who was P. A. Gillespie?

A. P. A. Gillespie is vice-president, under whom I work.

Q. What did he tell you?

A. He told me Mrs. Gillespie had a note in the amount of $2,500, and interest of $166.25, which had to be met, and she desired the company to advance the money to pay that in the nature of a loan.

Q. The corporation has no record on its books that this was a loan?

A. Except a notation in their ledger.

Q. Who made that notatoin?

A. I did.

Q. Pursuant to Mr. Gillespie's instructions?

A. Yes.

Q. Did Mrs. Gillespie give a note for that loan?

A. No.

Q. Or any security?

A. No.

Q. Did it provide for any interest?

A. No, sir.

Q. Did she ever pay any interest?

A. No, sir.

Q. Has the loan ever been repaid?

A. No, sir.

Q. Up to this time?

A. Not to this time.

Mr. Anderson: That is all.

Mr. Rorschach: That is all."

Mrs. Maud Gillespie, the petitioner, testified in her deposition (R. 69):

"Mr. Rorschach: Q. And how much did the company pay you in the year 1935?

A. $17,666.25.

Q. Now, under this amended agreement the company was obliged to pay you $15,000.00 for the year 1935. Can you explain the additional $2,666.25 that was paid you in 1935 by the company?

A. Well, I had a mortgage on a building in Hollywood and I didn't have the money to pay it off so they lent me the money to pay that mortgage off.

Q. And what was the amount of that that they let you have?

A. Well, they let me have $2,666.25."

It is submitted to Your Honors that the Board having found that the Commissioner of Internal Revenue erred in his determination, then it left the Commissioner's determination without any presumptive validity in any respect and it then became necessary for the Board to determine from the evidence and the facts taxpayer's correct tax liability for the year 1935. The only evidence before the Board was that of petitioner's witness Miss Reynolds, in which she testified on both direct and cross examination that the $2,-666.25 was a loan to Mrs. Gillespie and was so shown on the ledger of the company's books and the testimony of the petitioner.

The fact that Mrs. Gillespie had a contract with the corporation was presumed by the Board to warrant the assumption that the loan was in fact not a loan but a payment on account of the contract. We say that this is stretching the presumptive correctness of the Commissioner's determination. As was said in *Mount* v. *Commissioner, supra:*

> "There must be a limit beyond which the presumptive correctness of the Commissioner's determination may not be stretched in order to defeat a taxpayer. On the facts appearing in this record, the burden which the taxpayer carried of establishing that there was no fair market value for his share was sustained."

It is submitted to Your Honors that no evidence was introduced before the Board upon which the Board could find other than that the sum of $2,666.25, received by the taxpayer during the year 1935, was a loan. The petitioner made out her case and no further duty rested upon her to offer testimony with respect to an issue in which the burden of proof then rested upon the Commissioner.

It was held by the Board in *Rainbow Gasoline Corporation* v. *Commissioner,* 31 B. T. A. 1050, that the failure to establish an interest deduction for the years 1928 and 1929 for which the Commissioner had contended in his letter of determination and which the Board sustained did not warrant the presumption that the deficiency should be increased by the disallowance of an interest deduction for the year 1930, claimed by the respondent at the time of trial. There was no proof on the part of the Commissioner with respect to the increased deficiency claimed for the year 1930, even though there was no proof that any interest was in fact ever paid. In that case, the Board said:

> "At the hearing respondent also claimed such increase in the deficiency for 1930 as would result from the inclusion in petitioner's income for that year of the amount of $1,635.23 allowed as a deduction for accrued interest, on the ground that there was no legal liability on the part of the petitioner to pay interest on the account of the Henderson Company, and hence the deduction for accrued interest in 1930 had been erroneously allowed.
>
> "In support of its contentions, petitioner offered the testimony of its general auditor to the effect that in December, 1930, interest was accrued on the books on the average balance of the Henderson Co. account for each of the years 1928, 1929 and 1930 pursuant to the instructions of the general manager of the petitioner corporation.
>
> "The issue joined by the pleadings of the parties

filed prior to the hearing having raised specifically the question whether there was any legal obligation on the part of the petitioner to pay interest on the account of the Henderson Co., the mere proof of accrual on the books of the petitioner is insufficient, we think, to establish the liability, respondent's contention being that the accrual was erroneous because of the lack of legal obligation to pay. There is no proof that any interest was in fact ever paid, nor that the petitioner was legally liable to pay interest, or, if so, at what rate, nor that the general manager of petitioner was authorized to direct the accrual, and it appears that no interest was accrued for 1928 or 1929 until in December, 1930. In these circumstances the interest deduction claimed by the petitioner for 1928 and 1929 must be disallowed for lack of proof.

"Petitioner further contends that in any event the increased deficiency for 1930 claimed by respondent must be denied for the reason that the burden was upon respondent to prove that the allowance of the deduction for that year was erroneous, and no proof on this point was offered by respondent.

"In the situation presented here, we think that petitioner's argument is sound. *No duty rests upon the petitioner to offer testimony with respect to an issue on which the burden of proof rests on the respondent.* The presumption was that what had been done by the Commissioner was correct. No testimony was offered to show that it was not. We therefore hold that the revisions in deficiencies asked for by respondent should not be allowed." (Italics ours.)

IV.

In the alternative, if any part of the sum of $15,000.00 received by Maud Gillespie from F. A. Gillespie and Sons Company during the year 1935 was taxable, then only such portion of the $15,000.00 is taxable as represents 3 per cent of what an annuity would have cost on May 15, 1929, as would have produced the sum of $15,000.00 per annum during the lifetime of Maud Gillespie.

The Board held that the petitioner on May 15, 1929, agreed to the transfer of certain properties to F. A. Gillespie and Sons Company and, as part consideration, the company agreed to pay the petitioner two annuities to pay the sum of $15,000.00 per year for life and $10,000.00 per year for life (R. 142 and 146).

The Board found, further, that the conveyance of the property by petitioner was made for two purposes, namely: *First,* as the purchase of a specified annuity to herself during her life; *second,* the remainder over as a gift of the excess of the value of such properties over the cost of acquiring the annuities for the benefit of her children and her grandchildren (R. 146). The Board further found (R. 148) that the petitioner on November 16, 1933, agreed to the suspension of the guaranteed dividend payment of $10,000.00 annually (R. 118). During the years 1935 and the other years up to and including the date of the hearing nothing had been paid on the guaranteed dividend payment (R. 148) and the petitioner donated back to the company all of these payments.

Testimony by the petitioner at R. 67 is as follows:

> "Q. Now, this contract of May 15, 1929, by which you were obliged to turn over this property to the company, did you turn over the property and execute the deeds and documents and conveyances and all the matters that pertained to the dividends of $10,000.00 a year?

Have you made any change with respect to those payments, or any amendment to that contract?

A. Yes, I have.

Q. Do you recall the nature of that change?

A. Well, I was receiving—shall I tell you the amount I was receiving at that time?

Q. Yes.

A. I was receiving $15,000.00 a year in monthly payments and at the end of the year $10,000.00, I suppose in the nature of a dividend, and I turned back the $10,000.00 to the company for investment provided that Mr. Gillespie would do the same thing.

Q. And has that agreement been carried out?

A. Yes, it has."

Maud Gillespie could have purchased from a reputable life insurance company doing business in the United States an annuity which would have paid her the sum of $15,000.00 per year for life on May 15, 1929, for the sum of $196,537.50 (R. 149). An annuity could have been purchased by Maud Gillespie from a life insurance company doing business in the United States on May 15, 1929, which would have paid her $10,000.00 per year for life for $131,025.00; or the two annuities totaling $25,000.00 could have been purchased for $327,562.50 (R. 150).

If any portion of the $15,000.00 received by Maud Gillespie from F. A. Gillespie and Sons Company during the taxable year 1935 is taxable, then only so much is taxable as represents 3 per cent of the cost of acquiring an annuity from a reputable life insurance company on May 15, 1929, which would have paid Maud Gillespie the sum of $15,000.00 per annum for life.

The Board held that Maud Gillespie should be taxed on both annuities for the year 1935, even though she was only receiving payment under one of them. What an anomalous situation! If a taxpayer had ten annuities that had cost him

$100,000.00 each and was only receiving payment of, say, $5,000.00 a year under one of the annuities and nothing from the other nine, then under the theory propounded by the Board, the taxpayer would be required to pay three per cent of the cost of the ten annuities, or $30,000.00, although he had received only $5,000.00 from the one annuity.

The Board found that it was Mrs. Gillespie's intention to make a gift or contribution of the excess value of the properties to the corporation for the benefit of her children or grandchildren. Obviously it was her intention, and the Board so finds (R. 148), to make a contribution of the $10,000.00 annual payment for at least a period of three years, beginning November 16, 1933.

The Member in his opinion concedes the donative intent of the petitioner in donating to the corporation and to her children and grandchildren the remainder of the value of the property over the cost of the so-called annuities as a gift or contribution for the benefit of these children or grandchildren. Would it not be just as reasonable to perceive the donative intent of the petitioner in her amendment to the contract of May 15, 1929, on November 16, 1933? If she was donating property in excess of the cost of two annuities, one for $15,000.00 and one for $10,000.00, on May 15, 1929, could she not just as reasonably donate the payment or the additional value of the so-called $10,000.00 annuity in 1933 when she entered into the new agreement relieving the company of the $10,000.00 dividend guarantee?

With respect to the property turned over to the corpoation, Mrs. Gillespie made this statement (R. 71):

> "Oh, yes, surely, I turned this over so that my sons and my grandchildren would benefit by it."

Again, at R. 72, she stated:

> "Well, I figured that was turned into the company for the benefit of my children and my grandchildren."

At R. 73 she stated:

> "Well, I made—I gave my property to the company to safeguard my children and my grandchildren."

After the payments were made to her during her lifetime, it was Mrs. Gillespie's intention to consider the remainder over as a gift or contribution to the corporation for her children and grandchildren. Upon being asked this question (R. 73):

> "And did you consider the remainder over the value of this property as a gift or contribution to your children?",

she replied:

> "It was just a gift to my children and my grandchildren."

In *Ellerson* v. *Grove*, 44 F. (2d) 493, the Circuit Court said that a gift is a voluntary transfer of property without consideration and that the elements necessary to validate a gift are the donor's intent, delivery and acceptance by the donee. At page 496, the court said:

> "A 'gift' is a voluntary transfer of property from one to another without consideration. To validate it, three things are necessary: Donor's intention, delivery of the article, and acceptance by donee. Where a gift is consummated, it is as valid in law as anything else. *Farrington* v. *Tennessee*, 95 U. S. 679, at page 683, 24 L. ed. 558."

The gift of a portion of the property is to be inferred from the fact which is stipulated, that the property transferred by the petitioner to F. A. Gillespie and Sons Company under the contract of May 15, 1929, far exceeded the cost of purchasing an annuity. *G. Wildy Gibbs,* 28 B. T. A. 18; *Anna L. Raymond,* 40 B. T. A. 244; *May Rogers,* 31 B. T. A. 994.

It is therefore submitted to Your Honors that assuming, but not admitting, that the 1935 receipts was not in the

nature of a deferred payment on a sale and that section 22 (b) (2) of the Revenue Act of 1934 is constitutional, then the taxpayer could be taxed no more than three per cent of the cost of an annuity purchased on May 15, 1929, which would produce $15,000.00 per year. The Board found that the cost of such an annuity would have been $196,537.50 and that petitioner's taxable income from that source for the year 1935 would be three per cent of that amount, or $5,896.12, plus the sum of $2,666.25, which the Board held not to be a loan.

It is insisted that there is no basis under section 22 (b) (2) of the Revenue Act of 1934 upon which to tax the taxpayer upon the alleged cost of an annuity when she received nothing from the annuity. Conceding that the taxpayer purchased two annuities, there is no authority under section 22 (b) (2) of the Revenue Act of 1935 which permits the Commissioner of Internal Revenue to exact a tax from the taxpayer based upon the so-called purchase of an alleged annuity, when the taxpayer receives nothing from that "annuity" during the taxable year.

Conclusion.

In conclusion, the taxpayer rests her case upon the following points and cases cited in the brief in support of same:

I.

The Board erred and should have found that the payment made to Maud Gillespie in the calendar year 1935 by virtue of the terms of the contract of May 15, 1929, was an agreement for sale and was on the basis of a deferred payment and no taxable gain was realized until the cash payments exceeded the cost. F. A. Gillespie and Sons Company was an oil company and was not in the insurance business nor licensed under the laws of the State of Oklahoma to engage in the insurance business or in the business of grant-

ing annuities. If the contract is construed to be an annuity, then F. A. Gillespie and Sons Company has violated the laws of the State of Oklahoma and the contract is void. The presumption is in favor of supporting the validity of the contract; hence, the only construction that can be placed upon the contract is that of an agreement for sale. The cost of the property conveyed by Mrs. Gillespie in 1929 being in excess of $700,000.00 and less than $100,000.00 having been received up to January 1, 1935, there could be no gain arise out of the receipt of $15,000.00 by taxpayer during the year 1935.

II.

Section 22 (b) (2) of the Revenue Act of 1934 is unconstitutional and void if it be held to have any application in the instant case, for the reason that the three per cent provision is an arbitrary rate and in the case of this taxpayer imposes a tax on capital not apportioned among the states.

III.

The Board erred in finding that $2,666.25 was not a loan to taxpayer from F. A. Gillespie and Sons Company. There is no evidence to support any other finding.

IV.

In the alternative, if any part of the sum of $15,000.00 received by Maud Gillespie from F. A. Gillespie and Sons Company during the year 1935 was taxable, then only such portion of the $15,000.00 is taxable as represents three per cent of what an annuity would have cost on May 15, 1929, as would have produced the sum of $15,000.00 per annum during the life of Maud Gillespie. The Board found as a fact that two "annuities" had been acquired by Maud Gillespie, one for $15,000.00 per year and one for $10,000.00 per year, and that the $10,000.00 per year annuity had been donated back to the company by a supplemental contract of November 16, 1933. The Board and the Commissioner of Internal

Revenue are without authority to find an assessment against the taxpayer based upon an annuity from which the taxpayer received nothing during the year 1935. Section 22 (b) (2) of the Revenue Act of 1934 does not authorize such an exaction, if it be conceded that it is constitutional, and our attention has not been called to any other section of the Revenue Act which authorizes any such exaction. The rule which should be applied in this case has been well stated by Lord CAIRNS and has been restated in many federal tax decisions, *Partington* v. *Attorney General,* L. R. 4 H. L. 100, 122:

> "I am not at all sure that in a case of this kind—a fiscal case—form is not amply sufficient; because as I understand the principle of all fiscal legislation, it is this: If a person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute."

All of which is

Respectfully submitted,

HAROLD E. RORSCHACH,
JACK L. RORSCHACH,
HAROLD C. HARPER,
Counsel for Petitioner.